SUPREME COURT OF

IN THE

Supreme Court of the United States

October Term, 1974

No. 74-46

EQUITY SECURITIES CORPORATION, a Corporation and EQUITY FUNDING CORPORATION, and LYMAN SPURLOCK, an Individual,

Petitioners,

vs.

MARY F. EL KHADEM,

Respondent.

Respondent's Opposition to Petition for a Writ of Certiorari.

ARNOLD O. STEELE,
Attorney at Law,
206 Financial Centre,
7765 Girard Avenue,
La Jolla, Calif. 92037,
(714) 459-4116,
Attorney for Respondent.

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Statement of the Case.

Lyman Spurlock, an Agent of Equity Securities Corporation and Equity Funding Corporation, counseled Respondent to invest in "Investment Plan" of Nationwide Investment Corporation. At his suggestion and counseling, Respondent did invest in said plan, which embodied a series of financial transactions as follows:

(1) The Investor borrowed money on a note for the amount of the loan using cash or securities as collateral and pre-paid interest thereon to secure an immediate tax deduction. The lending agreement required Investor to maintain a collateral to loan ratio of 175% so that Investor was required to pledge more collateral as the market value of the pledged securities declined.

(2) Using the Investor's note, cash for pre-paid interest and collateral, Nationwide secured a bank loan in the amount of the face value of the Investor's note.

(3) The loan proceeds were used to purchase Mutual Funds which were to be held as collateral for loan in an individual escrow account in the Investor's name. It was anticipated that the Mutual Funds purchased and held as collateral would appreciate over and above the value of the loan by time of maturity.

(4) Actually, there were no individual Escrow Accounts. Instead, Nationwide pooled the collateral of all Investor's in an account in Nationwide's name. Nationwide then repledged this pooled collateral to secure loans for different lending institutions. *The proceeds of these loans were used for Nationwide's own business and investment purposes!!* (emphasis added.)

(5) When the market declined in the first half of 1970 Nationwide and the Defendants advised Respondent to "Convert" her assets in Mutual Funds to Treasury Bills and advised her to execute a second note for the purchase of Treasury Bills, the note again to be secured by Plaintiff's collateral.

(6) The same pattern of rehypothecation and use of the proceeds by Nationwide for its business purposes followed. The market declined, and the Respondent met all collateral calls. However, the Respondent's collateral, together with collateral of other investors, was lost through foreclosure on loans made by various lending institutions to Nationwide.

The Loan and Security Agreement provided in part:

9. ". . . lender (NATIONWIDE) shall have full and complete right and power to assign this agreement or any part thereof, and to rehypothecate for lender's financing any or all collateral of bor-

rower to secure lender's borrowings in an amount not to exceed borrower's indebtedness to lender, decreased by any unearned interest prepaid by borrower, and increased by any accrued earned interest due lender. Lender's pledgee or pledgees shall have no responsibility or requirement to determine whether its loan or their loans to lender meet the aforesaid loan limitations and shall be fully protected on any loan or loans made by it or them against the security of lender's rehypothecated collateral."

10. "Rights of Lender and Collateral. Lender shall have all the right of an owner in dealing in the collateral securing this loan."

The Investor also signed an authority to mortgage or pledge (hypothecation agreement) which was addressed as follows:

"To: Banks, Isurance Companies, Financial Institutions, Lenders to NATIONWIDE INVESTMENT CORPORATION.

The undersigned has assigned and transferred to NATIONWIDE INVESTMENT CORPORATION the above described property, of which the undersigned is/are the sole owners. For a valuable consideration, the undersigned hereby gives and grants to NATIONWIDE INVESTMENT CORPORATION the continuing right and power to mortgage or pledge such property to addressee, as security for any or all present or future obligations of NATIONWIDE INVESTMENT CORPORATION to addressee, such mortgage or pledge to be in such form and with such terms and conditions as shall be required by addressee.

The undersigned waives the right to require addressee to proceed against anyone liable in connection with any of said obligations or to realize upon any other security therefore, as a condition of or prior to realizing upon the property described above, and addressee is authorized at any time to release and deliver any or all of said property to or in accordance with instructions of NATIONWIDE INVESTMENT CORPORATION.

.....

PLEDGOR (INVESTOR)"

The Respondent makes no claim that the Mutual Funds were not registered or lacked a prospectus. She urges either that the Promissory Notes executed by her constituted a security, or that the entire transaction with Nationwide, including the borrowing of money, the execution of promissory notes, the pledging of collateral and the execution of loan and security agreements, constituted a security or investment contract which should have been registered pursuant to the Securities Act of 1933, and the Securities Exchange Act of 1934.

Question Presented.

Is a loan transaction a "security" under the Securities Act of 1933 and the Securities Exchange Act of 1934 when the provisions thereof permit the lender to pool the Investor's collateral for the purpose of borrowing money to be used for lender's business purposes?

ARGUMENT.

The Petitioners persuaded the Respondent to invest in a scheme in which Respondent thought she was borrowing money under an arrangement where she would obtain a tax deduction for prepaid interest on a note the proceeds of which would be invested in Mutual Funds (later U.S. Treasury Obligations). Respondent further believed the collateral would be deposited in an escrow in an individual account in her name and that as long as she met collateral calls, her investment was secure. Respondent did not realize that under Paragraphs 9 and 10 of the Loan and Security Agreement, Nationwide could pool her collateral with the collateral of other investors and rehypothecate this "pool of collateral" to secure loans to finance the business purposes of Nationwide. In these transactions the Respondent played a passive role having nothing to do with the decision of Nationwide to pool and rehypothecate the collateral, nor with the management of the funds obtained from the collateral for use in Nationwide's business operations. The economic reality of the transaction was that the investors provided capital for Nationwide in the form of prepaid interest and collateral. The pooling and rehypothecation by Nationwide placed the investors in a common enterprise, the success of which depended on the managerial ability and integrity of Nationwide. Unknowingly, the investors furnished "risk capital" for the speculative operations of Nationwide. The Respondent needed the protection of the registration provisions of the act to reveal the

implications of the pooling and rehypothecation provisions.

In *S.E.C. v. W. J. Howey, Company,* 328 U.S. 293 at 299, the Court stated:

> "The purpose of the act is to compel 'full and fair disclosure relative to the issuance of any types of instruments that, in our Commercial World, fall within the ordinary concept of the security . . . Congress intended the definition of 'security' to embody a flexible, rather than a static principal, one capable of adaptation to meet the countless and variable schemes devised by those who seek the use of money of others on the promise of profits."

The Court continued at page 298, and stated:

> "In searching for the meaning and scope of the word 'security' forms should be disregarded and emphasis should be on 'economic reality'."

The Court proceeded to define "security" as a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.

> "The term investment contract is undefined by the Securities Act or by relevant legislative reports. But the term was common in 'blue sky' laws in existence prior to adoption of the Federal Statute, and although the term was also undefined by state laws, it had been broadly construed by State Courts so as to afford the investing public a full measure of protection. Form was disregarded for substance and emphasis was placed on economic reality . . ."

The *Howey* case in a footnote on page 298 cites *Moore v. Stella,* 52 Cal. App. 2d 766, in which the Court said at 788:

> "It has been the consistent policy of the State as reflected in the various definitions of 'security' to subject to regulation all schemes for investment regardless of the forms of procedure employed, which are designed to lead investors into enterprises where the earnings and profits of business or speculative ventures must come through the management, control and operations of others, and which, regardless of form, have the characteristics of operations by corporation, trusts or similar business structures."

That the Federal Courts look to State Law to define a "security" is emphasized in the case of *Mr. Steak v. River City State, Inc.* (Colorado) 324 Fed. Supp. 640 (1970) at 646, in which the Court said:

> "Since no Federal Court has yet considered the risk capital approach, we must look to State Law for its basic tenets."

The Court further stated,

> "that the Howey case noted that prior State Judicial determinations had 'crystalized' the meaning of the definitions employed by Federal Security Law and look to State 'blue sky' laws to interpret the Federal Act. We consider California experience under a Security law similar to the Federal Act as particularly instructive in this regard. The seminar case in California Security Law which signals the departure from prior definitions of securities is *Silver Hills Country Club vs Sobieski,* 55 Cal 2nd 811. In that case, the purchase

and improvements of facilities for a Country Club were financed by the sale of memberships in the Club. Members had no right to the income or assets of the Club, but could use its facilities . . . The California Court held that a Security Interest had been created. Silver Hills had solicited risk capital to develop the Club . . . there was a substantial risk that the venture would not succeed . . . *the (California) Corporations Securities Act extends even to transactions where capital is placed without expectations of material benefits, and that any attempt an issurer to raise funds for a business venture or enterprise requires a permit where there is an indiscriminate offering to the public at large, where the persons solicited are selected at random; where the investors assume a passive position; and the issurer conducts the enterprise with other people's money. (Emphasis added).* The Court further stated that the Corporations Security Act defines 'security' so broadly as to protect the public against spurious schemes, however ingenuously devised to attract risk capital."

That Nationwide made a Public Offering is reflected in the case of *Securities and Exchange Commission v. Nationwide Investment Company, et al.,* Civil Action Number 70-1449-IH United States District Court, Central District of California, in which the S.E.C. stated in its Memorandum of Points and Authorities in Support of Motion for Temporary Restraining Order and Preliminary Injunction, that the Nationwide program had been sold to some 400 Investors who had paid Nationwide over $8,900,000 in the form of prepaid interest.

The Nationwide scheme was ingenuously structured as a loan transaction. The Act covers all schemes to obtain money from Investors for investment in a common scheme with the anticipation of profits and in which the Investor assumes a passive role. The flexibility of the act is reflected in the case of *Los Angeles Trust and Mortgage Exchange v. S.E.C.*, 254 F. 2d 199 at 211, where the Court said:

> "We feel we must point out, however, that irrespective of what a purchase price note secured by a second trust deed may be under California Law, the view taken by the Supreme Court in Securities Exchange Commission vs C. M. Joiner Leasing Corporation, 320 U.S. 344, 'The dominating general purpose' of Section 2(1) of the Act (15 USCA Sec. 77(b)(1) and it's 'generally expressed legislative policy indicates that' . . . novel, uncommon, or irregular devices . . . are also reached if it be proved that as matter of fact that they were widely offered or dealt in under terms or courses of dealing which establish their character in commerce as 'investment contracts', or as 'any interest or instrument commonly known as a security'. "

As stated in *Tcherepnin v. Knight*, 389 U.S. 332 at 345:

> "From the language of the Act the reports of Congress and from the interpretation of the Securities Exchange Act of 1933, it is obvious that the Federal Courts construe the Act broadly enough to protect the public against all schemes devised to attract risk capital where the Investor assumes a passive role. *The very heart of the act is to compel full and fair disclosure* of all types of instru-

ments that are dealt with in our society whether the enterprise is speculative or nonspeculative." (Emphasis added.)

Reasons for Denying Writ.

The decision below is an application of the principal that the Court will look through the form and penetrate to the substance of the transaction. Utilizing the form of a note, escrow agreement, and loan agreement, all bearing the indicia of a loan with collateral agreement, the scheme was a cleverly contrived guise for raising venture capital by Nationwide under the camoflage of a loan transaction. The substance of Nationwide's scheme was to rehypothecate the collateral of an Investor to raise funds for its own business operations. The decision below does not have a significant effect on the financial community because financial institutions do not rehypothecate the collateral of borrowers to secure funds for their own business operations. In the legitimate financial community the collateral of borrowers is returned when the loan is paid, or liquidated and credited against the balance due in event of default by the borrower. No legitimate financial institution rehypothecates collateral of borrowers to raise capital for its business operations. The decision below represents no departure from established principals and introduces no uncertainty into Securities Law. Nationwide offered its program to some 400 Investors, according to the Securities and Exchange Commission. It was a novel, uncommon or irregular devise offered to the public in the form of a loan, but was in reality a scheme which enabled Nationwide to use the collateral of the Investors to raise funds for its business purposes. The collateral of the Investor and proceeds from the

rehypothecation were managed by Nationwide and the security of the collateral and proceeds therefrom depended upon the managerial integrity and ability of Nationwide.

Conclusion.

The complexity of the Nationwide plan with the implications of the rehypothecation and pooling provisions demanded a disclosure through the filing of registration statement so that the Investor might understand that by pooling and rehypothecating the collateral the borrowing transaction would be converted into one where the Investor's capital became involved in a common enterprise, the success of which depended on the management of others.

Respectfully submitted,

ARNOLD O. STEELE,
Attorney at Law,
Attorney for Respondent.